

## **Legislative Background of Stranded Costs in the Virginia Restructuring Act**

### **Introduction:**

This document traces the development of the treatment of stranded costs in the Virginia Electric Utility Restructuring Act. A review of the extensive effort by the joint subcommittee established under SJR 91 and the legislative history of the Restructuring Act (SB 1269) shows why up-front calculations and asset-valuation as means of quantifying stranded costs were deliberately rejected in favor of the approach used in the Act.

### **SCC Statements on Stranded Costs, Late 1990s: Up-front Quantification a "Recipe for Disaster"**

During the intensive regulatory and legislative studies conducted in the years preceding passage of the Virginia Electric Utility Restructuring Act, the State Corporation Commission and its staff consistently warned against attempts to quantify stranded costs. The SCC warned that such activities may be "a recipe for disaster" (Draft Working Model for Restructuring the Electric Utility Industry in Virginia, November, 1997 at p. 88, hereinafter Draft Working Model, November 1997) and as an exercise that could "unintentionally undermine the ultimate objective" (SCC Draft Stranded Costs Benefit Legislation, July, 1998, at p. 1, hereinafter SCC Draft, July, 1998) of electric competition.

In various reports and submissions to the SJR 91 Joint Subcommittee, the SCC and its staff said administrative determinations of stranded costs would be extremely inaccurate for the following reasons:

- Such determinations would be extremely sensitive to unpredictable future changes in electricity market prices. The SCC observed that "long-term market prices of a sensitive, non-storable essential product with highly volatile weather-sensitive demand cannot be estimated within the bounds of reasonable accuracy." (SCC Draft, July, 1998, at p. 2) A deviation of plus or minus 15 percent from projected market prices could "either double or eliminate a \$2.5 billion base estimate of stranded costs" (SCC Draft, July, 1998, at p. 2).
- Administrative determinations would also rely on inaccurate and unpredictable projections of the cost of existing assets. The projections, in some cases, would have to extend decades into the future, since some "existing utility assets may have a remaining useful life of over 30 years." (SCC Draft, July, 1998, at p. 2) Factors such as potential life-extensions of assets and new environmental upgrades would further complicate the calculations, according to the Commission's July 1998 submission.
- Economic models used in administrative stranded costs determinations are unrealistic, severely flawed and unreliable. "The economic model upon which most of these market price projections appear to be based is the perfectly competitive model where

prices approach marginal costs" (Draft Working Model, November, 1997, at p. 89), the SCC staff said.

- Divestiture – the method of stranded costs quantification favored by some other restructuring states – would not accurately determine such costs. Mandated divestiture was a "drastic action . . . very difficult, probably impossible to undo" and might lead to sale prices that did not accurately reflect the assets' real value, according to SCC Director of Economics and Finance Richard J. Williams. (Presentation to the Task Force on Stranded Costs and Related Issues, by Richard J. Williams, May 26, 1998, at p. 10, hereinafter Presentation to the Task Force, May 26, 1998.)

While denouncing rigid, up-front calculations, the SCC's July 1998 draft legislation argued that stranded costs recovery mechanisms must be marked by "reasonable and necessary flexibility." (SCC Draft, July, 1998, at p. 1) The Commission staff also endorsed the "lost revenue" theory of stranded costs by offering the opinion that such costs do not exist in the absence of competition. The clearest statement of this theory was offered by Williams in his May 1998 remarks: "There can be no stranded costs until there is competition. As long as the strandable costs are in the utility's rate base and are included in the rates charged customers, nothing has been stranded and the utility is being fully reimbursed for the assets it uses to provide service." (Presentation to the Task Force by Richard J. Williams, May 26, 1998, at p. 2.)

A more complete record of SCC-related statements regarding issues concerning up-front administrative calculations of stranded costs is found in **Attachment A** to this document.

## **SJR 91 Joint Subcommittee: Legislative Development of Stranded Costs Concepts**

After the 1998 passage of House Bill 1178 committing Virginia to electric supply competition, the SJR 91 joint subcommittee studying the restructuring process began an effort to develop a comprehensive electric deregulation bill. One of its first actions after conclusion of the 1998 session was appointment of a Stranded Costs and Related Issues Task Force, chaired by Sen. Richard Holland (D-Windsor) and Del. John Watkins (R-Chesterfield). The task force, the joint subcommittee, and later a drafting panel appointed by the subcommittee conducted an exhaustive review of the stranded costs issue, solicited input from a full range of stakeholders, and evaluated a variety of definitions and recovery mechanisms. The findings of the legislative groups operating under SJR 91 in large measure determined many of the stranded costs recovery mechanisms found in the Restructuring Act.

### **Work of Stranded Costs and Related Issues Task Force – May-October 1998**

The task force met from May through October 1998 and collected information, opinions and suggestions from a variety of stakeholders, ranging from incumbent utilities to consumer groups. The SCC and the Virginia Attorney General's Division of Consumer Counsel also participated in the deliberations.

Although there were considerable differences of opinion at times among the stakeholders, the task force reported the following consensus regarding the elements of stranded costs. According to the consensus, stranded costs included:

- Generation asset devaluation;
- Potential losses associated with above-market, purchased power contracts (including cooperatives' wholesale power contracts); and
- Regulatory assets defined as "previously deferred, generation-related costs or obligations incurred by a regulated electric utility in providing electricity prior to generation deregulation." ("Report of the Joint Subcommittee Studying Restructuring of the Electric Utility Industry to the Governor and the General Assembly of Virginia," p. 13, hereinafter Report of the Joint Subcommittee.)

A November 2002 staff report to the Legislative Transition Task Force sheds more light on the SJR 91 deliberations regarding stranded costs. The 2002 report noted that the question of when costs become stranded prompted a wide range of opinions from stakeholders. For example, the Office of the Attorney General, Division of Consumer Counsel, noted that no stranded costs or benefits can exist "unless and until there is effective competition in the retail electric generation market and customers leave their current provider in favor of a competitor." ("Quantifying Incumbent Electric Utilities' Stranded Costs, Report to the Legislative Transition Task Force," November 19, 2002, p. 3.) This position is similar to the SCC staff view, voiced in May, 1998, that no stranded costs can exist until customers switch.

Regarding stranded costs collection mechanisms, the task force found general support for wires charges and capped or frozen rates. (Report of the Joint Subcommittee, p. 14.) This reflected a general acceptance of the "lost revenue" approach to stranded cost recovery. There was less agreement on the recovery period during which capped rates and wires charges would apply. Recovery periods ranging from three to 12 years were recommended by various stakeholders. (Report of the Joint Subcommittee, p. 14.)

The SJR 91 task force reported that most stakeholders agreed that "neither stranded costs nor stranded benefits can be calculated in advance of restructuring. The key variable - market prices for generation - is indeterminate until a competitive market for such generation exists in fact." (Report of the Joint Subcommittee, p. 13.) The final report also stated that stakeholders "agreed that the State Corporation Commission should play a significant role in addressing stranded costs and stranded benefits" (Report of the Joint Subcommittee, p. 14), but there was a wide divergence of opinion on what that role would incorporate. For example, an SCC submission to the SJR 91 task force in the fall of 1998 suggested that the Commission should "determine and quantify stranded costs and benefits." Most electric utilities, on the other hand, did not endorse an up-front stranded costs calculation. ("Draft Matrix, SJR 91 Stranded Costs and Related Issues Task Force," October 1998.)

**By late 1998, therefore, the restructuring subcommittee was well aware of the dangers and complexities of attempting to make formal stranded costs calculations part of a state restructuring plan.**

## **Virginia Electric Utility Restructuring Act embodies consensus on stranded cost recovery.**

In November and December of 1998, the joint subcommittee's drafting group put together the main components of restructuring legislation. This process involved solicitation of legislative language from all interested stakeholders. Regarding stranded costs, the working draft contained the concepts of capped rates and wires charges and thereby reflected a centering on the "lost revenue" approach. But, despite the extensive work of the Stranded Cost and Related Issues Task Force, consensus had not yet been found on the stranded cost issue. It therefore became one of the issues to be addressed by the full joint subcommittee meeting as a "drafting group of the whole." The subcommittee did, however, take the significant step of rejecting a proposal that going-in rate cases must be conducted to set the rate caps. Such rate cases would have necessitated an attempt to quantify the stranded cost exposure of incumbent utilities. Rate caps were instead set by settlements achieved under alternative rate plans.

### **A collaborative process among stakeholders addressed stranded costs.**

When the joint subcommittee met during the session on January 18, 1999, a substitute addressing stranded costs was offered by a coalition of stakeholders that met to resolve the stranded cost issue. This coalition included, among others, Virginia Power, AEP, ODEC, independent power producers, the Attorney General's Office of Consumer Counsel, ALERT and the Virginia Committee for Fair Utility Rates. Their proposal incorporated concepts that had been previously advocated by various stakeholders. This involved a definite transition period with capped rates and a non-by-passable wires charge to allow incumbent utilities to recover stranded costs. Consistent with the prior decision of the subcommittee that rejected going-in rate cases, it did not require any front-end quantification of such costs. This outcome satisfied to a great extent the concerns and interests of virtually all stakeholders. It afforded consumers protection from market volatility while providing incumbent utilities an opportunity to recover stranded costs. Through the wires charge as calculated in the bill, incumbent utilities are held financially harmless when their customers switch to another supplier and this helped overcome any resistance that incumbents might have in providing retail choice.

### **General Assembly reaffirmed stranded cost approach**

The joint subcommittee adopted the coalition's substitute, as well as other amendments, and this became part of the restructuring bill introduced by Senator Norment as SB 1269. As this bill worked its way through the General Assembly, numerous amendments were made to clarify intent, accommodate differences among types of incumbent utilities, protect consumers, and provide legislative oversight. The fundamental method of addressing stranded costs, however remained intact. A test of this occurred when an amendment was attached to the bill in the House Commerce, Insurance and Banking Committee that would have required quantification of stranded costs in order to determine if these costs were over-recovered or under-recovered. When the bill reached the House floor, this language was rejected and instead, the Legislative Transition Task Force was directed to monitor whether the recovery of stranded costs, **as provided in 56-584**, is likely to result in over-recovery or under-recovery.

An examination of the debate on the floor of the House of Delegates on whether to strip the amendment proposed in the House Commerce, Insurance and Banking Committee supports the proposition that the House of Delegates clearly rejected a policy that required a quantification of stranded costs.

### **The Restructuring Act's stranded cost provisions are inextricably linked**

Most importantly from the standpoint of the stranded cost issue is the fact that these components of the bill are mutually dependent and inextricably linked. The capped rate protects consumers from price spikes while giving utilities needed certainty with regards to revenue during a transition period. The market prices projected annually by the SCC enable wires charges to be calculated using the capped rate and facilitate choice by giving consumers a "price to beat." The capped rate period from January 1, 2001, to July 1, 2007, provides a reasonable time for consumers and utilities to adjust to competition and is critical in terms of utility recovery and mitigation of stranded costs. The Act works with each component performing more than one critical function and these functions are interdependent. This means that disturbing any one vital part will disrupt the whole mechanism. The beauty of this design is that no absolute quantification of stranded costs is intended or needed.

**The stakeholders and the General Assembly were satisfied with this arrangement as reflected in both testimony in support of the bill and the large majority by which it was approved in both houses. To revisit the treatment of stranded costs in SB 1269 by isolating it and attempting to quantify it would disrupt the foundation of the Restructuring Act and would ignore the concurrence of the stakeholders and the wisdom of the General Assembly in addressing this issue.**

### **Conclusion:**

The reasons for rejection of quantification of stranded costs in the language of the Restructuring Act remain valid today. Stranded costs are dynamic quantities that constantly fluctuate and there was, and is no, consensus on the correct means of calculation. The Act provides a workable method that is adjusted annually, and a reasonable period for stranded cost recovery that was negotiated, agreed upon, and settled in 1999.

ATTACHMENT: State Corporation Commission Comments on Stranded Costs Recovery,  
1997-98